STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6120

Tariff filing of Central Vermont Public Service)
Corporation requesting a 12.9% rate increase, to)
take effect July 27, 1998)

Docket No. 6460

Tariff filing of Central Vermont Public Service)
Corporation requesting a 7.6% rate increase,)
to take effect December 24, 2000)

PREFILED SURREBUTTAL TESTIMONY OF WILLIAM STEINHURST ON BEHALF OF THE VERMONT DEPARTMENT OF PUBLIC SERVICE

April 20, 2001

Summary: Dr. Steinhurst's testimony addresses CVPS rebuttal to issues regarding the Department's rate making recommendations and presents the Department's revised recommendations on those issues and for setting rates overall for this case.

Prefiled Surrebuttal Testimony
of
William Steinhurst

Q. Please state your name and occupation.

A. My name is William Steinhurst, and I am the Director for Regulated Utility Planning for the Vermont Department of Public Service ("Department", "DPS"). My business address is 112 State Street, Montpelier, Vermont.

Q. Have you previously filed testimony in this proceeding?

A. Yes. I pre-filed direct testimony in this docket.

Q. What is the purpose of your testimony?

A. My surrebuttal testimony addresses criticisms of my prefiled testimony and the Department's recommendations in this proceeding.

Q. Please summarize your surrebuttal testimony.

A. I reaffirm the Department's position regarding the propriety of prudence and used and useful disallowances that the Board could impose on Central Vermont Public Service Corp. ("CVPS," "the Company") under traditional rate making for power supply mismanagement, including both management of the Hydro Quebec/Vermont Joint Owners Contract ("the Contract") and the Company's actions regarding the proposed power uprate at Vermont Yankee ("VY"), including the issues of supposed environmental and risk benefits of the Contract. With minor exceptions related to the Contract and a correction to the amount related to Vermont Yankee, I reaffirm the Department's position regarding the amounts of the prudence and used and useful disallowances that the Board could impose.

I discuss and reaffirm the Department's rate making recommendation of

forbearance from imposing the full traditional disallowance with conditions, including a year 2001 write down of $25 million and various other provisions.[1] I also explain why, in the alternative, the Board can and should reimpose the return on equity ("ROE") penalty imposed by the Board in Docket 5701/5724 ("75 bp penalty"), but converted to an equivalent year 2001 write down, instead of an ongoing penalty.[2] I also address the Company's assertion in its rebuttal testimony that it has met the Board's standard for permanently rescinding the 75 bp penalty.

Q. What outcome does the Department seek in this case?

A. The Department's objective in this proceeding is to obtain the result most consistent with the general good of the state and the ratepayers. We believe that this can best be done through a rate order that upholds traditional rate making principles, but forbears from imposing the full disallowances that would normally apply, setting rates so as to provide sufficient revenue for the Company to retain its investment grade rating *and* to minimize the burden on ratepayers consistent with that objective. We further believe, based on the information and analysis available to us at this time, that the Board can achieve those purposes by issuing an order consistent with our testimony in this case.

Q. Has the Company's rebuttal testimony altered the Department's primary or alternative rate making recommendation with regard to prudence and used and useful issues?

---

[1]While recognizing that DPS witnesses Schulz and Deronne present the bottom line rate recommended by the Department, including the effect of this $25 million write down, for convenience I will follow Mr. Boyle in referring to the $25 million write down recommendation regarding prudence and used and useful issues, with the associated conditions I propose, as the Department's "primary rate making recommendation."

[2]In a similar vein, I will refer to this proposal, with the associated conditions I propose, as the Department's "alternative recommendation."

A. No, it has not. There have been a few changes to our position regarding various cost of service items in response to the Company's prefiled rebuttal, and other DPS witnesses present those changes in their surrebuttal testimony. Also, DPS witness Sherman explains a change to his estimate of the excess power costs for the Docket 6460 rate year due to the Company's management actions preceding the decision of the VY Board of Directors regarding the power uprate decision. And DPS witness Ross explains certain revisions to the Department's calculation of the amount of a write down that would leave CVPS with an investment grade rating. But these adjustments alter neither the amount of nor the fundamental supporting analysis for the primary and alternative recommendations I offered in my direct testimony.

Q. Please explain why your primary rate making recommendation remains unchanged.

A. As explained by DPS surrebuttal witness Chernick, the Company's rebuttal case does not result in any significant change to our prior calculation of prudence damages for the Docket 6120 and 6460 rate years. (These rate years provide the data necessary to understand the prudence damages for the period 1/1/99 through 7/1/01.) He also describes a few, small adjustments that might be appropriate and shows that some of them would actually make the Contract *less* cost effective, increasing the estimated damages. Witness Biewald shows that the Company's rebuttal does not provide any basis for altering his previous estimates of the post-2001 above market costs of the Contract. Both witnesses also provide argument rebutting CVPS's claim of environmental and risk benefits for the Contract.

With regard to the used and useful portion of our primary rate making recommendation, Mr. Biewald thoroughly rebuts the Company's testimony, demonstrating that the used and useful doctrine is and should be part of traditional rate making under Vermont law and that the estimates of post-2001 above market costs of the Contract in his direct testimony should be relied on, without any adjustment for supposed environmental

or risk benefits of the Contract, for determining a used and useful disallowance if the Board were to do so.

Therefore, based on their testimony and my independent judgement, I conclude that the prudence damages the Board *could* impose under traditional rate making are substantially the same as those set out in our direct testimony and are far greater than the Company could absorb while remaining an investment grade firm, even with the few minor changes the Company's rebuttal supports. To achieve an outcome that maintains investment grade status for the Company, I continue to recommend that the Board forbear from imposing that full disallowance, and as a condition of that forbearance require a one-time year-2001 write down of $25 million conditioned as set out in my direct testimony.

Q. If, because of the Supreme Court's decision in the Docket 6018 appeal or for some other reason, such as a concern that an investment grade rating cannot be maintained, the Board were to find that it cannot or should not impose the above prudence and used and useful disallowances that would be available under traditional rate making, how should the Board proceed?

A. As explained in my direct testimony, I understand that the Docket 5701/5724 75 bp penalty may be reimposed, and that the Board is not prevented from modifying or increasing the ROE penalty or even replacing it with a different remedy.[3] If the Board may reimpose the 75 bp penalty or a similar but larger penalty, then clearly the Board can fashion from that starting point a remedy that is fair to ratepayers. (As I explain below, the Board should not accept the argument that the Company has satisfied the discharge

[3]If the Board may fashion a "different" remedy "as long as CVPS's service is being impaired as a result of the high price of its power," I would argue that this flexibility encompasses imposing the traditional prudence disallowance discussed above, or the used and useful disallowance above, or a combination of the two. In re Tariff Filing of Central Vermont Public Service Corporation, No. 98-214, slip op. at 18 (Vt. S. Ct, Feb. 9, 2001).

condition established when the Board first imposed the 75 bp penalty.)

However, if the Board finds that reimposition of an ROE penalty is the proper starting point for addressing prudence and used and useful issues for the Contract in this case, the Board should, again, forbear, conditioning its forbearance on an equivalent one time year 2001 write down. I believe that a present value about $13 million for a reimposed 75 bp penalty for the life of the Contract from 2001 forward is one representation of such an equivalent penalty. The Board should also further condition this forbearance as set out in my direct testimony.

Q. Please explain why it is important to condition reimposition of an ROE penalty in the manner you recommend.

A. In seeking to retain an investment grade rating for the Company, it is important to provide finality with regard to the disposition of the Contract prudence and used and useful issues. The Board has made it clear in its Docket 6107 Order that forbearance is permitted to the extent sufficient to "advance the art" and fair to ratepayers. If the Board is to forbear on the condition that there be some penalty, we must consider how best to fashion that penalty to make it as acceptable as possible to investors and rating agencies. In my opinion, the best way to do so–the way that maximizes the amount the Board can safely disallow and, hence, fairness to ratepayers–is to require any penalty to be a one time write down absorbed as quickly as possible, preferably immediately upon the Board's Order. I believe that investors and rating agencies would find a one time write down significantly more final and helpful than a stream of disallowances or penalties of equivalent present value and equal fixedness, but extending out many years.

Q. Does this argument also apply to your primary rate making recommendation?

A. Yes, it does.

Q. With regard to your alternative rate making recommendation, has CVPS presented evidence claiming that it should not be subject to reimposition of the 75 bp penalty?

A. Yes. For example, in his prefiled rebuttal testmony, Mr. Boyle recites various activities that CVPS has undertaken in attempts to mitigate its excess power supply costs. He concludes"there is no justification for a finding that the Company has failed to meet the standards set out in the Docket 5701/5724 Order." Boyle pfrt. 3/30/01 at 14-16, 57.

Q. Do you agree?

A. No. To see why not, we need only examine the original language of the Board's 5701/5724 Order.

In Docket 5701/24, the Board ruled that the power cost penalty imposed on CVPS "should remain in place until the Company *demonstrates, through tangible results, that it has eliminated the excessive power costs imposed on customers* by ineffective and improvident management decisions, or that it is on *a reasonable and equitable path towards doing so*." Order of 10/31/94 at 171, emph. added.

The Company's rebuttal devotes much space to the *efforts* the Company has made to eliminate excessive power costs, but no where do they claim to have eliminated those excess costs.[4] Mr. Boyle, however, asserts that the mitigation efforts he recounts are sufficient to find that the Company is "on a reasonable and equitable path towards doing so." This assertion does not stand up to scrutiny. Mr. Boyle describes these efforts in his prefiled rebuttal.

In 1996, after careful review of CVPS's management efforts up to that date, including Sellbacks 1, 2, and 3, the Board concluded that the Company had not met this

[4]The Company also asserts that, after various adjustments are made, there are no excess costs remaining for the future of the Contract. See, for example, Exh. DPS-BEB-7. DPS Witnesses Biewald and Chernick demonstrate that this is not so, and that on the order of $100,000,000 present value of excess costs remain as of 2001.

standard and cautioned the Company that "in the future, if it has still failed to meet the standard of 'eliminating excess power costs' altogether," a "more substantial record of tangible achievements that address power costs over the future, and/or adequate information about the broader nature of management plans for addressing all categories of those costs in the future" would be necessary to justify concluding that the Company is on a reasonable and equitable path" towards eliminating those excess power costs. Docket 5863, Order of 4/30/96 at 16 and fn. 14. Clearly Sellbacks 1, 2 and 3 cannot satisfy the requirements for lifting the penalty.

To the evidence of power cost mitigation offered in Docket 5863, the Company now adds the following items: Sellback 4, the ice storm arbitration, various internal restructuring and cost cutting measures, the attempted sale of VY, and the Company's participation in Docket 6270 seeking to mitigate QF contract costs.

Sellback 4 has delivered net savings, but as shown in Exh. Boyle-29, they are modest, limited in time, and negative in some years. As for the attempted sale of VY, the ice storm arbitration and Docket 6270, as ambitious as they are, each has incurred significant up front costs and may or may not "eliminate excess power costs," being speculative in nature. As of this writing and based on press releases by the Joint Owners, it appears that net benefits from the ice storm arbitration can be characterized as modest, at best. Docket 6270 is still examining preliminary matters. One attempt to sell VY has failed, and, while another attempt is underway, it remains to be seen whether such a sale would provide power cost mitigation benefits greater than continuing to own and operate the plant. In any event, none are proof of a "tangible achievement" as required by the Board's Order. And, however laudable the Company's internal restructuring and cost cutting measures may be, they do not constitute mitigation of excess power costs nor has it been demonstrated that will save more than the Company should any way under prudent and economical management or to meet its own financial ends.

Clearly, the standard set by the Board in Docket 5701/5724 has not been met, and,

under the provisions of the Board's suspension of that penalty in Docket 5863, the penalty may be reimposed. The original provisions of the penalty also state that a different penalty may be imposed later. Clearly, if "a different penalty" is permitted, a similarly structured, but larger penalty would be, too. And the Vermont Supreme Court has not precluded either an increased or modified ROE penalty. *In re Tariff Filing of Central Vermont Public Service Corporation*, No. 98-214, slip op. at 18-19 (Vt. S. Ct, Feb. 9, 2001).

Q. What other reasons can you offer for the proposition that the Board would be justified in reimposing an ROE penalty?

A. DPS surrebuttal witness Sherman shows why, as a result of discovery received subsequent to his and my direct testimony, it is clear that preceding the decision of the VY Board of Directors on January 15, 1999, CVPS acted in a manner inconsistent with meeting the needs of its ratepayers at the lowest present value life cycle cost and also inconsistent with the management decisions a reasonable manager would have made. Such behavior by CVPS was imprudent, in my opinion. Please note carefully that no DPS witness testifies in favor of any explicit or implicit dollar disallowance of VY or CVPS costs due to this imprudent act by CVPS. The Department does not seek any such dollar disallowance. Rather, I assert that CVPS's actions prior to the VY Board of Directors meeting on January 15, 1999, were fundamentally inconsistent with the Board's Docket 5701/5724 charge to eliminate "excessive power costs imposed on customers by ineffective and improvident management decisions, or that it is on a reasonable and equitable path towards doing so." That fact then forms one additional basis for reimposition of the Board's *previous* ROE penalty on CVPS, a penalty imposed for reasons having nothing to do with VY costs or management.

Q. Are there any new reasons you can offer in support of reimposing an ROE penalty?

A. Yes. DPS witness Lamont has pointed out an additional shortcoming in the

Company's management of its resources. Specifically, he shows that the Company did not manage its dispatchable load in a reasonable manner as part of its overall power supply management and, as a result, may have incurred excess power costs. He has not quantified those excess power costs, and we do not seek a specific dollar disallowance. However, I believe this is another instance of failure to take reasonable actions to eliminate excessive power costs and is, therefore, an additional basis for reimposing the Board's previous ROE penalty.

Q. In your prefiled direct testimony, you cited Company policies regarding "discretionary maintenance" of CVPS generating facilities as a further justification for reimposing the Board's previous ROE penalty. Do you still do so?

A. No. Mr. Boyle's prefiled rebuttal testimony explains that, in this policy, "discretionary" means "subject to cost benefit analysis" and asserts that there have been no instances where generator maintenance was not performed because it was found to be not cost effective. Relying on that testimony, I consider the matter resolved. However, given that the policy of the Company is one of discretionary approval for such expenditures, I recommend that the Company exercise care in its decision making about maintenance of owned generation, especially in view of recent voltage support contingencies experienced in Vermont.

Q. In their prefiled surrebuttal, DPS witnesses Chernick and Biewald explain why, factually, there is no environmental or risk benefit value that should be accorded to the Contract in estimating prudence damages or a potential used and useful disallowance. Suppose that, factually, there were some such value that flowed from entering into the Contract. If that were so, what effect should that have on calculating prudence damages?

A. None. The Company is entitled rates that provide it an opportunity to earn a reasonable rate of return under prudent and economical management. Such rates would

reflect the cash cost actually borne by the Company for prudently incurred expenses. There is no basis in traditional rate making for requiring ratepayers to pay the Company for any external benefits created by the Company's prudent actions. To do so would be to create an absurdity.

Q. Mr. Boyle argues that "Forbearance is no more than an arbitrary methodology designed to justify the imposition of penalties that would otherwise be inappropriate or illegal." Pfrt. at 92. Do you agree?

A. No. There would be nothing inappropriate or, as I understand it, illegal about the Board's imposing significant prudence or used and useful disallowances in this case. Our direct and rebuttal testimony demonstrates this in detail. Even if there were some bar to doing that, the Board can, as I understand it, clearly reimpose the 75 bp penalty (and, I believe, increase it or replace it with a different penalty). The open question is whether the Board should proceed to do so or fashion some lesser penalty. This is clearly within the Board's discretion as was explained in full detail in the Board's Order in Docket 6107.[5] My primary and alternative recommendations, conditioned as I propose, would be such a lesser penalty.

Mr. Boyle makes certain legal arguments about estoppel, which I understand to be erroneous, but then focuses on his "concerns" about how he thinks capital markets will perceive an Order implementing the Department's recommendations. Pfrt at 92. Specifically, he thinks capital markets will be concerned about "the Company's continuing

[5]The fact that Docket 6107 was settled does not alter this. The Board explained clearly in its Order that the Contract was imprudent and not used and useful, but that *despite that fact*, the Board could approve the settlement proposal as just and reasonable *provided* that it also found certain requirements were met. Thus, the Board has already ruled (and found that it *had* to rule in order to approve the Docket 6107 settlement) that the type of forbearance I propose here can be appropriate and lawful.

ability to collect its costs through rates."[6] He also states that "CVPS seeks final resolution to the outstanding issues that have clouded its ability to attract capital and impaired its financial position."

Either the primary or alternative recommendations I offer would provide CVPS with the "finality" it seeks, and I do not believe the capital markets would look askance at the Department's proposed resolution any more than they have at the outcome of Docket 6107.[7] Of course, no two companies are identical, but as DPS witness Ross points out that, with the rates and write down recommended by the Department, CVPS will have financial projections for 2001 through 2003 that support retaining an investment grade rating.

---

[6]This language may refer to "access to capital" issues or may be code for issues related to SFAS 71 or both. DPS witness Schultz addresses impacts of our recommendations on applicability of SFAS 71.

[7]For example, on March 5, 2001, only weeks after the appeal period expired on the Board's Order in Docket 6107, Moody's Investors Service upgraded GMP to investment grade. Moody's stated:

> The outlook for the ratings is now stable. The rating action reflects Moody's expectations for more stable and predictable earnings and cash flow following the January 23, 2001 approval by the Vermont Public Service Board of an agreement between GMP and the Vermont Department of Public Service (VDPS). On balance, the state regulatory decision indicates a more supportive stance than has been the case over the past three years. From Moody's perspective, *the regulatory decision favorably resolves the earlier credit concerns surrounding GMP due to the company's contract to purchase power from Hydro Quebec (HQ)*. Emph. added.

On April 3, 2001, S&P removed GMP from CreditWatch [sic] and stated "the outlook is positive." S&P also stated that, despite its concerns about GMP's continuing exposure under Sellback 97-01, GMP's ratings reflected "an average business profile," an important factor in determining credit ratings.

Q. How has CVPS characterized your proposed conditions for forbearance? Do you agree?

A. CVPS has portrayed the proposed conditions for forbearance as punitive, unnecessary, and harmful to access to capital. I disagree.

As explained in my direct testimony, these conditions are not punitive, but provide the necessary balance to ensure fairness to the ratepayers who, due to the improvident actions of the Company, must for the next 15 years pay more than they would under traditional rate making in order to enable he Company earn enough to provide safe, adequate and reliable service and to attract capital for those purposes. The appropriateness of those conditions flows from the standard for forbearance enunciated by the Board in its Docket 6107 Order.

In addition, DPS witness Frankel explained additional reasons, not related to forbearance on HQ penalties, for imposing the Department's Service Quality Plan, and her prefiled surrebuttal shows that the Company has not rebutted that position.

Mr. Boyle also complains about the proposed recapture mechanism. Pfrt. at 31. I believe his concerns are not justified. He characterizes the recapture mechanism as a penalty. As explained earlier in this answer that is a mischaracterization. Mr. Boyle also contends that the GMP recapture condition is justified by the fact that GMP is no longer on traditional rate making, which would not apply to CVPS. Actually, the situation as proposed by the DPS would be entirely analogous; if the Board forbears, as I recommend, CVPS, too, would have rates higher than necessary under traditional rate making. Next, he claims that the recapture mechanism would be a prohibited material change to the 75 bp penalty. I disagree for two reasons. First, material changes to the 75 bp penalty are not prohibited as I explained in my direct prefiled testimony. Second, even if the 75 bp penalty could not be materially changed, the Board may still impose conditions such as the recapture mechanism as a requirement for forbearing from increasing or modifying that penalty. Lastly, Mr. Boyle says that the recapture mechanism may be detrimental to CVPS"s access to capital. I have explained above why this should not be so. Mr. Ross

reaches the same conclusion in his direct prefiled testimony.

Q. Would the Department's primary and alternative recommendations, if ordered by the Board, result in equitable administration of the Board's rate making authority?

A. Yes, it would. The standard for rate making is just and reasonable rates, but the Board has great discretion in the methods it adopts to achieve that outcome. Certainly this discretion must be exercised in an equitable manner, but there is nothing in the Department's recommendations that is inequitable. For rates to be fair, means they must be fair between CVPS and its customers. See, Board order of 4/30/96 in Docket 5863 at 14, citing 10/31/94 order in 5701/24 at 171: "It is our responsibility, as a matter of fairness, to ensure that ratepayers do not solely bear the financial consequences of those improvident management decisions; the Company must bear a substantial share of the consequences of its own actions." While CVPS has born some of the excess power costs incurred as a result of its imprudent actions, not all of the consequences recited by Mr. Boyle are relevant and some were the result of the company's own choices. Boyle pfrt. at 7 ff. But more importantly, ratepayers have still borne the lion's share of consequences to date, and there are many millions of dollars of future consequences that must also be treated fairly between the Company and its ratepayers.

The DPS recommendation, if adopted by the board, would apply the board's precedent (set out in the Board's Order Docket 5132 and affirmed in detail in its Order in Docket 6107) and espoused policy regarding forbearance in an equitable manner (as explained in those portions of the Docket 6107 Order quoted in my direct prefiled). In fact, if anything my recommendation provides an outcome skewed in favor of CVPS because its retained earnings after either of the Department's proposed write downs are very significant, while GMP's were barely sufficient to permit payment of dividends, and the resulting financial results will assure CVPS access to the capital markets.

Q. Are the Department's recommendations designed to provide stability for CVPS and the Vermont electric industry as a whole?

A. Yes, they are. We contend, our recommendation leaves CVPS financially stable and puts Contract issues behind us. Ratepayers must be protected to the extent compatible with providing safe, adequate and reliable service. The Department's recommendation is intended to and, we believe, will do exactly that.

Q. Does that conclude your testimony at this time?

A. Yes.